otherwise be entitled, provided the purpose in distributing the cash is to save the distributing corporation the trouble, expense, and inconvenience of issuing and transferring fractional shares (or scrip representing fractional shares), or issuing full shares representing the sum of fractional shares, and not to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation.

(b) *Illustration.* The application of paragraph (a) of this section may be illustrated by the following example:

Example. Corporation X is a large corporation whose stock is widely held by the public, no one shareholder owning more than 10 percent of the outstanding stock. The stock is listed on a recognized exchange and is currently selling at less than $75 per share. During the year the corporation pays a 3-percent stock dividend. Cash is paid to each shareholder in lieu of a fractional share to which he would otherwise be entitled. The distribution of cash in lieu of fractional shares is not intended to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation, but is intended to save the corporation the trouble, expense, and inconvenience of issuing and transferring scrip representing fractional shares. The general rule, and not the exception, applies in this situation.

(Sec. 305(c), 83 Stat. 614; 26 U.S.C. 305(c))

[T.D. 7039, 35 FR 7012, May 2, 1970]

§ 13.11 Revocation of election to report income on the installment basis.

(a) *In general.* Under section 453(c)(4) taxpayers who are dealers in personal property and who elected installment-basis income reporting, subject to the provisions of section 453(c)(1) (relating to change from accrual to installment basis), may revoke their previously made election.

(b) *Time and manner of revoking election.* The revocation by a taxpayer may be made by filing an amended return on an appropriate form or forms, such as Form 1040X for an individual taxpayer, for the year of change (the first year for which income was computed using the installment basis) and for each subsequent year for which a return was filed using the installment basis. The taxpayer should indicate on such amended returns that he is revoking an election to report income on the installment basis. Such revocation must be made within 3 years from the last date prescribed for the filing of the return for the year of change including any extension of time granted the taxpayer. In reporting income on the amended returns described in this section, the taxpayer shall use the accrual method of accounting.

[T.D. 7044, 35 FR 8823, June 6, 1970]

PART 14a—TEMPORARY INCOME TAX REGULATIONS RELATING TO INCENTIVE STOCK OPTIONS

AUTHORITY: 26 U.S.C. 7805.

§ 14a.422A–1 Questions and answers relating to incentive stock option transitional rules.

The following questions and answers relate to the application of incentive stock option (ISO) treatment to certain previously granted stock options, pursuant to section 422A of the Internal Revenue Code of 1954, as added by section 251 of the Economic Recovery Tax Act of 1981 (95 Stat. 172) (ERTA):

GENERAL DESCRIPTION OF SECTION 422A AND ITS TRANSITIONAL RULES

Q–1: What is the significance of new section 422A of the Code entitled ''Incentive Stock Options?''

A–1: Prior to the enactment of section 422a, the tax treatment of employee stock options generally was governed by section 83 of the Code and the regulations thereunder. Under those rules, the value of a stock option constituted ordinary income to the employee when granted only if the option itself had a readily ascertainable fair market value at that time. If the option did not have a readily ascertainable value when granted, it did not constitute ordinary income at that time. Instead, when the option was exercised, the difference between the value of the stock at exercise and the option price constituted ordinary income to the employee. An employer who granted a stock option generally was allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year.

Section 422A provides for incentive stock options (ISO's). Under this new provision there will be no tax consequences when an ISO is either granted or exercised, and the employee generally will be taxed at capital gains rates when and if the stock received on exercise of the option is sold. Similarly, no

business expense deduction will be allowed to the employer with respect to an ISO.

Q–2: What requirements must be met for ISO treatment under section 422A?

A–2: (a) Section 422A provides that the employee, in order to receive ISO treatment, must not dispose of the stock within two years after the option is granted, and must hold the stock itself for at least one year. If all requirements other than these holding period rules are met, tax is deferred until disposition of the stock, but gain (in an amount equal to the lesser of (1) the fair market value of the stock on the date of exercise minus the option price or (2) the amount realized on disposition minus the option price) is treated as ordinary income and the employer is allowed a deduction at that time.

(b) In addition, for the entire time from the date of granting the option until three months before the date of exercise (expanded to 12 months if employment ceased due to permanent and total disability), the option holder must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc. This requirement and the holding period requirement are waived in the case of the death of the employee.

(c) For an option to qualify as an ISO, the following conditions must be met:

(1) The option must be granted under a plan specifying the aggregate number of shares of stock which may be issued and the employees or class of employees eligible to receive the options. This plan must be approved by the stockholders of the granting corporation within 12 months before or after the plan is adopted.

(2) The option must be granted within ten years from the date the plan is adopted or the date the plan is approved by the stockholders, whichever is earlier.

(3) The option must by its terms be exercisable only within ten years of the date it is granted.

(4) The option price must equal or exceed the fair market value of the stock at the time the option is granted. This requirement will be deemed satisfied if there has been a good faith attempt to value the stock accurately, even if the option price is less than the stock value.

(5) The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by the employee.

(6) The employee must not, at the time the option is granted, own stock representing more than ten percent of the voting power of all classes of stock of the employer corporation or its parent or subsidiary. However, the stock ownership limitation will not apply if the option price is at least 110 percent of the fair market value (at the time the option is granted) of the stock subject to the option and the option by its terms is not exercisable more than five years from the date it is granted.

(7) The option by its terms is not exercisable while there is outstanding any ISO which was granted to the employee at an earlier time. For this purpose, an option which has not been exercised in full is outstanding until the expiration of the period which under its initial terms it could have been exercised. Thus, the cancellation of an earlier option will not enable a subsequent option to be exercised any sooner.

(8) In the case of options granted after 1980 the terms of the plan must limit the amount of aggregate fair market value of the stock (determined at the time of the grant of the option) for which any employee may be granted ISO's in any calendar year to not more than $100,000 plus a carryover amount. The carryover amount for an employee from any year after 1980 is one-half of the amount by which $100,000 exceeds the value at time of grant of the stock for which ISO's were granted in such prior year. Amounts may be carried over three years. Options granted in any year use up the $100,000 current year limitation first and then the carryover from the earliest year.

(d) Section 422A also provides that:

(1) Stock acquired on exercise of an ISO may be paid for with stock of the corporation granting the option.

(2) The difference between the option price and the fair market value of the stock at the exercise of an ISO is not an item of tax preference.

(3) The employee may have the right to receive additional compensation (in cash or property) at the time of exercise of the ISO so long as the additional amount is subject to inclusion in income under the provisions of sections 61 and 83 of the Code.

(4) An ISO will not be disqualified because of the inclusion of any condition not inconsistent with the qualification requirements.

Q–3: What are the transitional rules relating to ISO treatment under section 422A?

A–3: ERTA §251(c) provides the transitional rules relating to ISO treatment. That section initially limits the applicability of section 422A to options originally granted on or after January 1, 1976.

In the case of an option granted during the years 1976 through 1980, section 422A will apply only if (1) the option was exercised on or after January 1, 1981, or was outstanding on that date, and (2) the employer elects (in such manner as the Treasury Department provides) to have the option treated as an ISO (see A–4). (See A–12 for necessary section 422A qualification requirements.) The aggregate fair market value (determined at time

of grant) of stock for which an employee may be granted ISO's prior to 1981 may not exceed $50,000 per calendar year and $200,000 in the aggregate for the five-year period 1976–1980.

In the case of an option granted on or after January 1, 1976, and outstanding on August 13, 1981, paragraph (1) of section 425(h) of the Code shall not apply to either any change in the option terms (or the terms of the plan under which the option was granted) or the obtaining of shareholder approval, to permit such option to qualify as an ISO, provided such change and/or shareholder approval occurs on or before August 13, 1982. (Section 425(h) of the Code requires that if an option is changed, so that it is modified, extended, or renewed, the option shall be treated as newly granted as of the date of such change.)

ELECTION PROCEDURE AND SELECTION OF OPTIONS

Q–4: What is the procedure for electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981?

A–4: NOTE: The following procedure preempts the election procedure set forth in Temporary Regulation §301.9100–4T(d) of this chapter (TD 7793, 46 FR 54538 (November 3, 1981)). If, prior to December 21, 1981, a corporation has filed an election statement that conforms to the requirements of §301.9100–4T(d) of this chapter, such an election statement will be considered to have been properly filed. An election statement filed prior to December 21, 1981, that does not meet the requirements of either §301.9100–4T(d) of this chapter or this A–4, will not be considered to have been properly filed. In any event, a corporation may re-file the election statement, conforming it to the requirements of this A–4, and such re-filing will then constitute the only election (see A–9, regarding timely rescissions, for a possible reason a corporation may want to re-file).

A corporation may file only one election statement and that statement must include all options that are to receive ISO treatment. Thus a corporation that makes an election with respect to certain options granted before 1981 may not make any subsequent election with respect to other options granted before 1981. An election shall be made by attaching a statement to the employer's income tax return (or amended return) for the first taxable year during which either an option subject to the election or an option qualifying under the rules of section 422A is exercised. An election shall be made no later than the due date (including extensions) of the income tax return for such year, except that if the due date occurs before August 14, 1982, the employer will be permitted to make the election at any time prior to August 14, 1982, on a statement attached to an amended return. In any event, no election will be permitted after the due date (taking extensions into account) of the income tax return for the taxable year including December 31, 1982.

The statement must—

(a) Contain the name, address, and taxpayer identification number of the corporation.

(b) Identify the election as an election under section 251(c)(1)(B) of the Economic Recovery Tax Act of 1981.

(c) Specify, by employee, the options to which the election applies. For each option so elected, the filing must state the option's date of original grant (and, if applicable, date of most recent modification) and total exercise price (*i.e.*, the total number of shares subject to the option multiplied by the price per share).

All options that are subject to the election must meet the section 422A qualification requirements (see A–2(c)) at the time the election statement is filed. The only exception to this rule is the requirement, when necessary, of securing shareholder approval (see A–32 and A–34).

Q–5: In electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981, may a corporation select only those options that it wants to receive ISO treatment?

A–5: Yes. However the original grant dates—or later grant dates for options with section 425(h) amendments (see A–9)—of the options selected for ISO treatment will determine the new sequencing order for purposes of the ISO sequential exercise restriction (see A–2(c)(7)). For example consider the case of options granted in 1977, 1978, and 1979, and assume that in 1980 the 1978 option was modified to add a term beneficial to the employee (a modification which under 425(h) would be treated as the granting of a new option). If the 1977, 1978 (as modified), and 1979 options are now elected as ISO's, the sequencing order is as follows: the 1977 option must be exercised first, the 1979 option second, and the 1978 option (as modified) third. See also A–9 and A–38.

Q–6: In electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981, may a corporation select options on an option-by-option basis and/or an employee-by-employee basis?

A–6: Yes. Subject to the $50,000 per year and $200,000 aggregate limits (see A–3), a corporation may select for ISO treatment any or all options granted to any or all employees, subject only to plan requirements as to who must be benefited under a plan, as among different classes of employees.

Q–7: In electing ISO treatment for options granted during the years 1976 through 1980 and outstanding on January 1, 1981, may a corporation select only a portion of the elected option to receive such treatment?

A–7: Yes. Subject to the $50,000 per year and $200,000 aggregate limits (see A–3), a corporation may select for ISO treatment any portion of any option. If the option is not exercised prior to January 21, 1982, the option must be amended so that the ISO portion is clearly identified. When such a ''split'' option is exercised, separate stock certificates must be issued (or reissued)—one for the ISO stock and one for the non-ISO stock. See also A–15 and A–18.

ELIGIBILITY REQUIREMENTS AND ISSUES INVOLVING PRE-ENACTMENT MODIFICATIONS, DOLLAR LIMITATIONS, AND DUAL PLANS

Q–8: Is an option originally granted prior to January 1, 1976, and amended on or after January 1, 1976, eligible for ISO treatment?

A–8: No. For purposes of ISO eligibility, the controlling date is the date of original grant. A modification, extension, or renewal on or after January 1, 1976, of any option originally granted before that date, will not make such option eligible for ISO treatment, regardless of whether or not the option, as so modified, extended, or renewed, would be treated as newly granted within the meaning of section 425(h).

Q–9: If an option granted on or after January 1, 1976, was amended between its date of grant and August 13, 1981, will such an amendment affect the option's eligibility for ISO treatment?

A–9: An amendment to an otherwise eligible option (or plan) prior to August 13, 1981, will be subject to the rules of section 425(h). If, pursuant to section 425(h), the amendment is a modification, extension, or renewal of the option, such amendment shall be considered as the granting of a new option. In order for such an option to be eligible for ISO treatment, the option (and plan) must comply with the section 422A qualification requirements (see A–2(c)). The option will be deemed to have been granted on the date it was amended. Thus, the option price cannot be less than the fair market value of the stock on that date. If the corporation wishes to retain the original grant price (and grant date) of the option, the corporation may do so by rescinding the amendment that was either a modification, extension, or renewal pursuant to section 425(h), so long as such rescission occurs prior to the earliest of the exercise of the option, the election of ISO treatment, and August 14, 1982. To be effective, such rescission must apply to the entire option. For example, in the case of a $100,000 option granted in 1978 and amended in 1980, the corporation could not rescind the modification as to only half of the option, and then elect for ISO treatment both $50,000 of the option granted in 1978 and $50,000 of the option as amended in 1980.

Q–10: An option granted during 1978 was amended during 1980 to add the following features: An alternative stock appreciation right, the right to exercise the option with previously-acquired corporate stock, and the right to receive a cash bonus upon the exercise of the option. At the same time, the exercise period of the option was extended from five to ten years and the post-employment exercise period was extended from 3 to 18 months. If the option is to be elected as an ISO, which of the above amendments is either a modification, extension, or renewal within the meaning of section 425(h) so that the option will be treated as newly granted on the date it was amended?

A–10: Any one of the above amendments will cause the option, pursuant to section 425(h), to be treated as newly granted on the date it was amended.

Q–11: An option granted during 1978 was amended during 1980 to add the right to exercise the option with previously acquired corporate stock. During 1981, the corporation properly elected ISO treatment for the amended option and, pursuant to section 425(h), adjusted the option price upward so that it equaled the fair market value of the stock subject to the option as of the date of the 1980 amendment. During 1982, the employee intends to exercise the option and will pay cash. Under these circumstances, is the employee entitled to exercise the option at the 1978 option price?

A–11: No. The option price, as amended in 1980, is the option price. The application of section 425(h) to option amendments is not affected by whether or not the employee actually benefits from such amendments (but see A–9 regarding timely rescissions).

Q–12: Is an option granted on or after January 1, 1976, and exercised on or after January 1, 1981, eligible for ISO treatment, if, at the time of exercise, the option (or plan) did not meet all of the qualification requirements of section 422A and the transitional rules (see A–2(c) and A–3, respectively)?

A–12: No. Except in cases described in A–13 through A–15, and A–34, in order for an option to be eligible for ISO treatment it must, at the time of exercise, conform to all of the qualification requirements of section 422A and the transition rules. It is not possible to amend an exercised option retroactively, in order to correct non-conforming or missing terms, or to rescind an improper exercise.

Q–13: Is an option granted on or after January 1, 1976, and exercised on or after January 1, 1981, eligible for ISO treatment if, at the time of exercise, the terms of the option did not contain the ISO sequential exercise restriction (see A–2(c)(7))?

A–13: If the option was exercised prior to January 21, 1982, without containing the ISO sequential exercise restriction, such option may still be eligible for ISO treatment. The absence of the restriction will not disqualify an option if the employee in fact had no prior outstanding ISO's at the time the option in question was exercised. If the option was exercised on or after January 21, 1982, the absence of the ISO sequential exercise restriction will not disqualify an option if

the employee in fact had no prior outstanding ISO's at the time the option in question was granted. In order to identify prior outstanding ISO's, it will be necessary to take into account all options either elected or qualifying for ISO treatment (see A–5, A–9, and A–38).

Q–14: Is an option granted and exercised during 1981 eligible for ISO treatment if, at the time of exercise, the terms of the plan pursuant to which the option was granted did not contain the $100,000 per year limit on ISO grants (see A–2(c)(8))?

A–14: If the option was exercised prior to January 21, 1982, the absence from the plan of the $100,000 per year limit will not disqualify the option. ISO treatment will only be available, however, for exercised amounts that do not exceed the $100,000 limit. Those amounts in excess of the limit will be treated as non-ISO's. If it is necessary to ''split'' an exercised option because the $100,000 limit has been exceeded, separate stock certificates must be issued (or reissued) no later than January 21, 1982, one for the ISO stock and one for the non-ISO stock. If the option was not exercised prior to January 21, 1982, the rules of A–18 will apply.

Q–15: Is an option granted during the years 1976 through 1980, and exercised during 1981, eligible for ISO treatment if, at the time of exercise, the option, either alone or in conjunction with similarly granted options, exceeded the $50,000 per year limit (or the $200,000 aggregate limit) on ISO grants (see A–3)?

A–15: If the option was exercised prior to January 21, 1982, the fact that the aggregate fair market value of the stock exceeded the $50,000 per year limit (or the $200,000 aggregate limit) will not prevent the election of up to $50,000 of the option as an ISO (subject to the $200,000 aggregate limit). Those amounts in excess of the applicable dollar limits cannot be elected as ISO's. If it is necessary to ''split'' an exercised option because the applicable dollar limits have been exceeded, separate stock certificates must be issued (or reissued) no later than January 21, 1982, one for the ISO stock and one for the non-ISO stock (see also A–7). If the option was not exercised prior to January 21, 1982, the rules of A–18 will apply.

Q–16: Do the $100,000 per year limit (see A–2(c)(8)), and the $50,000 per year and $200,000 aggregate limits (see A–3) apply to all options granted to an employee or only to elected and qualifying ISO's?

A–16: All three limits apply only to elected and qualifying ISO's.

Q–17: Do the $100,000 per year limit (see A–2(c)(8)), and the $50,000 per year and $200,000 aggregate limits (see A–3) apply to the fair market value of the stock granted, or to the option price of the options granted?

A–17: The dollar limits apply to the fair market value of the stock granted. Thus, an employee who is also a 10 percent shareholder would be permitted to receive an ISO grant to purchase $100,000 worth of stock at an option price of $110,000 (see A–2(c)(6)).

Q–18: How do the $100,000 per year limit (see A–2(c)(8)), and the $50,000 per year and $200,000 aggregate limits (see A–3) apply to an option granted on or after January 1, 1976, and not exercised prior to January 21, 1982?

A–18: Such an option will not qualify for ISO treatment if, at the time it is exercised, the option amount is in excess of the applicable dollar limit. In order for such an option to qualify for ISO treatment, it must be ''split'' into an ISO and a non-ISO portion so that the ISO portion of the option does not exceed the applicable dollar limit. This option ''split'' must be accomplished prior to the exercise of the original option and the ISO portion of the option must be clearly identified. Any ''split'' option that was required, by its original terms, to be exercised in full, will still be required to be exercised in full after it is ''split.'' Upon the exercise of a ''split'' option, separate stock certificates must be issued—one for the ISO stock and one for the non-ISO stock. Additionally, if the option was granted on or after January 1, 1981, the terms of the plan pursuant to which the option was granted must be amended to add the $100,000 per year limit—before the option is exercised.

Q–19: How does the $50,000 per year limit (see A–3) apply to the case of an employee who was granted $100,000 of options in 1979, and who proposes to exercise these options $50,000 in 1982 and $50,000 in 1983?

A–19: Only $50,000 (valued as of the date of grant) of the stock for which options were granted in 1979 will be eligible for ISO treatment. The $50,000 per year limit relates only to the year of grant, not to the year of vesting (as in the case of installment options) or exercise. Additionally, no carryover provision applies to the $50,000 per year limit. Thus, even if the employee had not been granted any options in prior years, the result described above would not change.

Q–20: Is it permissible for a corporation to grant ISO's and non-ISO's under the same plan, or must such options be granted pursuant to separate plans?

A–20: Both ISO's and non-ISO's may be granted pursuant to one plan so long as such plan, by its terms, meets all of the ISO qualification requirements (see A–2 (c)). Additionally, each option granted pursuant to such a ''dual'' plan must be clearly identified as to its status, *i.e.*, ISO or non-ISO.

Q–21: May a single option agreement, issued pursuant to a plan, grant both ISO's and non-ISO's, or must such option agreements grant either only ISO's or only non-ISO's?

A–21: Both ISO's and non-ISO's may be granted pursuant to a single option agreement, so long as each option is clearly identified as to its status, *i.e.*, ISO or non-ISO,

and none of the options are subject to a ''tandem'' exercise arrangement (see A–39).

Q–22: When either amending an existing plan or creating a new plan that is to grant ISO's, is it necessary under the ISO qualification requirements (see A–2(c)) to specify only the aggregate number of total shares issuable under the plan, or must the aggregate numbers of ISO's and non-ISO's be specified?

A–22: Only the aggregate number of total shares issuable under the plan must be specified.

Q–23: Must either an option, or the plan pursuant to which the option is granted, contain a specific provision restricting the exercise of any ISO to within 3 months of termination of the employee's employment (see A–2(b))?

A–23: No. An otherwise eligible option will receive ISO treatment if it is, in fact, exercised within 3 months of termination of the employee's employment (except in cases of disability or death). Moreover, an option term that permits exercise beyond 3 months after termination of employment, will not disqualify an option from receiving ISO treatment.

Q–24: In order for an option to be eligible for ISO treatment, the option price must equal or exceed the fair market value of the stock subject to the option when the option is granted. This requirement will be deemed to have been satisfied if, at the time of grant, there was a good faith attempt to accurately value the stock—even if such valuation should subsequently prove to be in error (see A–2(c)(4)). Do similar good faith rules apply to the $100,000 per year and 50 percent carryover limits (see A–2(c)(8)), and the $50,000 per year and $200,000 aggregate limits (see A–3) relating to the value of ISO options granted per employee?

A–24: Yes.

REQUIRED OPTION AND PLAN AMENDMENTS

Q–25: What types of amendments, under the transitional rule governing changes in the terms of options and plans (see A–3), will not invoke the application of section 425(h)?

A–25: The transitional rule waives the applicability of section 425(h) only with respect to amendments which are necessary in order to permit an option or plan to meet the minimum qualification requirements of section 422A (see A–2(c)). Amendments to add or delete permissible terms (such as the right to use previously acquired corporate stock to exercise the option) do not fall within the waiver of section 425(h).

Q–26: Is an option granted after August 13, 1981, under a plan (or option terms) which fails to meet the qualification requirements of section 422A (see A–2(c)), eligible for ISO treatment?

A–26: No. However, prior to being exercised, such an option (or its plan) may be amended to meet the qualification requirements of section 422A and thus become eligible for ISO treatment. All such amendments, where an option is granted after August 13, 1981, will be subject to the rules of section 425(h) (see A–3). Thus, for example, if an option is granted on September 1, 1981, it may qualify as an ISO only if it is amended, and the option price is at least equal to the fair market value of the stock as of the amendment date.

Q–27: May the terms of an outstanding option that was granted on or after January 1, 1981, and that automatically qualified for ISO treatment, be selectively amended so as to disqualify the option from receiving ISO treatment? May the option be cancelled?

A–27: Yes. However, despite either the cancellation of the option or any disqualifying amendment to the option (or the plan pursuant to which the option was granted), the original option will, for purposes of the ISO sequential exercise restriction, be treated as an outstanding ISO until such option, by its original terms, expires by reason of lapse of time (see A–2(c)(7)).

Q–28: May a non-ISO plan be amended so as to qualify only prospectively granted options for ISO treatment?

A–28: Yes. Amendments to a non-ISO plan, so as to meet the section 422A qualification requirements (see A–2(c)), will only apply to previously granted and outstanding options when such amendments, by their terms, are clearly intended to have retroactive effect.

Q–29: If a corporation grants new ISO's in exchange for the cancellation of outstanding non-ISO's, will such an exchange violate either the 422A qualification requirements (see A–2(c)) or the transition rules (see A–3)?

A–29: No, so long as such an exchange does not constitute a ''tandem'' exercise arrangement (see A–39).

SHAREHOLDER APPROVAL ISSUES

Q–30: If a plan received shareholder approval within 12 months before or after the date such plan was originally adopted and it is being amended to conform to the qualification requirements of section 422A (see A–2(c)), will new shareholder approval be required?

A–30: For purposes of the section 422A qualification requirements, new shareholder approval will be required only if the original plan did not specify the aggregate number of issuable shares or identify the eligible employees (or class of employees).

Q–31: Does the amendment of a plan to add the $100,000 per year and 50 percent carryover limits (see A–2(c)(8)), relating to options granted on or after January 1, 1981, require new shareholder approval?

A–31: No.

Q–32: If a plan never received shareholder approval, or did not receive such approval within 12 months before or after the plan was adopted, will such plan conform to the qualification requirements of section 422A (see A–2(c)) if shareholder approval is obtained prior to August 14, 1982?

A–32: Yes, but only if an option granted pursuant to the plan was outstanding on August 13, 1981 (see A–3). If no option granted pursuant to the plan was outstanding on August 13, 1981, such plan must be re-adopted by the granting corporation and, if necessary, amended to meet the section 422A qualification requirements. Shareholder approval must be obtained within 12 months before or after the date the plan is re-adopted. Consequently, any option granted after August 13, 1981, and before the date the plan is re-adopted, will be treated as newly granted on the date of re-adoption of the plan.

Q–33: If an option was granted pursuant to no plan at all and the option was outstanding on August 13, 1981, may a plan now be instituted and shareholder approval obtained, as part of the amendments permitted under the transitional rules (see A–3)?

A–33: Yes.

Q–34: Assuming that shareholder approval is required with respect to certain amendments made to conform an option outstanding on August 13, 1981 (or its plan), to the qualification requirements of section 422A (see A–2(c)), may such option be exercised prior to securing shareholder approval and still be eligible for ISO treatment?

A–34: Yes, so long as shareholder approval is secured within the one-year period specified by the transitional rules (see A–3).

SEQUENTIAL EXERCISE ISSUES

Q–35: Will the existence (or exercise) of prior stock options which are neither elected nor qualified to receive ISO treatment, ever prevent the exercise of an ISO under the 422A sequential exercise restriction (see A–2)?

A–35: No. However, if an option that is either elected or qualified to receive ISO treatment, contains sequencing restrictions that refer to options other than ISO's, the option will continue to be burdened by such restrictions. The deletion of such non-ISO sequencing restrictions from the option is not an amendment necessary in order to qualify an option for ISO treatment as permitted by the transitional rules (see A–3). Consequently, section 425(h) would be applicable to such an amendment.

Q–36: Under the sequencing rules applicable to section 422 qualified stock options, an option was permitted to be exercised out of sequence so long as it was issued at a higher price than prior outstanding options (section 422(c)(6)). Will a similar exception to the sequencing restriction be applicable to ISO's?

A–36: No. Section 422A does not contain such an exception to the sequencing restriction.

Q–37: How does the section 422A sequential exercise restriction (see A–2(c)(7)) apply to an ISO granted in one year that, by its terms, can only be exercised in installments over a period of years?

A–37: Such an installment ISO is the grant of a single option. The section 422A sequential exercise restriction would restrict the exercise of any later-granted ISO until either the exercise or expiration of all installments of this earlier-granted ISO.

Q–38: Assume that an option granted and exercised during January of 1982 automatically qualifies, by its terms, for ISO treatment. During February of 1982, the same employee exercised a second option, one that had been granted during 1978. Prior to the exercise of the 1978 option, it was amended under the transitional rules (see A–3) so that it would conform to the section 422A qualification requirements (see A–2(c)). If the 1978 option is properly elected to receive ISO treatment (see A–4), will such an election adversely affect the 1982 option's status as an ISO?

A–38: Yes. The election of the 1978 option to receive ISO treatment will automatically disqualify the 1982 option. If the 1982 option is to qualify as an ISO, it cannot be exercised prior to the exercise or expiration of all ISO's previously granted and outstanding on the 1982 option's date of grant (see A–2(c)(7)). When the 1982 option was granted during January of 1982, the 1978 option was already granted and outstanding for purposes of the section 422A sequential exercise restriction.

RECEIPT OF PROPERTY OR CASH UPON EXERCISE OF AN ISO

Q–39: Section 422A provides that ISO treatment will be available even though the employee has the right to receive cash or other property at the time of the exercise of the option, so long as such property is subject to inclusion in income under section 83 (see A–2(d)(3)). To what extent does section 422A permit the use of tandem options and stock appreciation rights (SARs) in connection with ISO's?

A–39: A tandem stock option, wherein two options are issued together and the exercise of one affects the right to exercise the other, is not permitted because such a tandem option arrangement may be used to evade the section 422A qualification requirements (see A–2(c)).

A tandem ISO–SAR, wherein an ISO and an SAR are granted together and the exercise of one affects the right to exercise the other, is permitted so long as the SAR, by its terms, meets the following requirements:

(a) The SAR will expire no later than the expiration of the underlying ISO.

(b) The SAR may be for no more than 100% of the spread, *i.e.*, the difference between the exercise price of the underlying option and the market price of the stock subject to the underlying option at the time the SAR is exercised.

(c) The SAR is transferable only when the underlying ISO is transferable, and under the same conditions.

(d) The SAR may be exercised only when the underlying ISO is eligible to be exercised.

(e) The SAR may be exercised only when there is a positive spread, *i.e.*, when the market price of the stock subject to the option exceeds the exercise price of the option.

If all of the above requirements are met, for purposes of the 422A sequential exercise restriction (see A–2(c)(7)), a tandem ISO–SAR will be considered exercised in full when either the underlying ISO or the SAR is exercised. Additionally, SAR's may be paid in either cash or property, or a combination thereof, so long as the section 83 income inclusion rule applies to any property so transferred.

[T.D. 7799, 46 FR 61840, Dec. 21, 1981, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

PART 15—TEMPORARY INCOME TAX REGULATIONS RELATING TO EXPLORATION EXPENDITURES IN THE CASE OF MINING

Sec.

AUTHORITY: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805.

SOURCE: T.D. 6907, 31 FR 16776, Dec. 31, 1966, unless otherwise noted.

§ 15.0–1 Scope of regulations in this part.

The regulations in this part relate to expenditures of the type described in section 615(a) or in section 617(a)(1) paid or incurred after September 12, 1966. The regulations in this part do not apply to the income tax treatment of mining exploration expenditures paid or incurred before September 13, 1966, and no election made pursuant to the provisions of the regulations in this part shall have any effect on the income tax treatment of exploration expenditures paid or incurred before such date. See § 15.1–4 for rules relating to treatment of exploration expenditures paid or incurred during taxable years beginning before September 13, 1966, and ending after September 12, 1966.

§ 15.1–1 Elections to deduct.

(a) *Manner of making election*—(1) *Election to deduct under section 617(a).* The election to deduct exploration expenditures as expenses under section 617(a) may be made by deducting such expenditures in the taxpayer's income tax return for the first taxable year ending after September 12, 1966, for which the taxpayer desires to deduct exploration expenditures which are paid or incurred by him during such taxable year and after September 12, 1966. This election may be exercised by deducting such expenditures either in the taxpayer's return for such taxable year or in an amended return filed before the expiration of the period for filing a claim for credit or refund of income tax for such taxable year. Where the election is made in an amended return for a taxable year prior to the most recent year for which the taxpayer has filed a return, the taxpayer shall file amended income tax returns, reflecting any increase or decrease in tax attributable to the election, for all taxable years affected by the election. See section 617(a)(2)(C) for provisions relating to the tolling of the statute of limitations for the assessment of any deficiency for any taxable year, to the extent the deficiency is attributable to an election under section 617(a). In applying the election to the years affected there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby, such as the deduction for charitable contributions, the foreign tax credit, net operating loss and other deductions or credits the amount of which is limited by the taxpayer's taxable income, and the effect that adjustments of any such items have on other taxable years. Amended returns filed for taxable years subsequent to the taxable year for which the election under section 617(a) is made by amended return shall apply the recapture provisions of subsections (b)(1)(B), (c), and (d) of section 617.

(2) *Election to deduct under section 615*—(i) *General rule.* The election to deduct exploration expenditures under section 615 shall be made in a statement filed with the district director, or director of the regional service center,